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In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 640

PORTLAND CEMENT COMPANY OF UTAH, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The question in this case is whether the computation of petitioner's depletable gross income from mining is governed by the proportionate profits method set forth in Section 39.23(m)-1(e)(3) of Treasury Regulations 118,[1] as the court of appeals held, or whether the regulation is invalid and petitioner is entitled to employ another method of its own devising.

Petitioner is an integrated miner-manufacturer of cement. It mines its raw material, cement rock, from its own quarry. In prior appeals in this litigation,[2] the

[1] Although Treasury Regulations 118 were promulgated under the 1939 Code, they are applicable under the 1954 Code, unless and until superseded by new Regulations. See Section 7807 of the 1954 Code.

[2] 338 F. 2d 798; 315 F. 2d 169; 293 F. 2d 826.

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court of appeals held that petitioner's mining operations terminated with the primary crushing of the crude mineral, and that petitioner's depletion base was its constructive income at that point.[3] There are no sales in the open market of cement rock as a crude mineral; it is mined only by integrated producers for their own use in manufacturing finished cement. In the absence of a market price from which the value of the crude mineral may be determined, Section 39.23(m)-1(e)(3) prescribes the proportionate profits method for computing gross income from mining. The method allocates the taxpayer's total gross income from sales of its manufactured product to mining and non-mining income in the same proportion as mining costs bear to the total costs of the product sold. This formula is mandatory, under the terms of the regulation, unless the taxpayer establishes to the satisfaction of the Commissioner that another method clearly reflects gross income from mining.

In the present case the court of appeals, reversing the district court, held that the proportionate profits

[3] Section 613(c)(4)(F) of the 1954 Code, added by Section 302 of the Public Debt and Tax Rate Extension Act of 1960, P.L. 86-564, 74 Stat. 290, 291-293, prospectively defined the mining of minerals to be used in manufacturing cement as including "all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln". By Section 4 of the Act of September 14, 1960, P.L. 86-781, 74 Stat. 1017, this new definition was made retroactive to earlier years at the election of taxpayers. Petitioner has not availed itself of this option for the years in question here, 1954 through 1956. Therefore, in accordance with decisions of this Court discussed below, its mining operations ended with the primary crushing of the cement rock.

method must be employed in computing petitioner's depletable mining income. This ruling is sound and there is no conflict in decisions or warrant for further review.

1. The pertinent part of Section 611(a) of the Internal Revenue Code of 1954 authorizes a "reasonable" depletion allowance "in all cases to be made under regulations prescribed by the Secretary or his delegate". Under Section 613 the depletion allowance in the case of hard minerals is a percentage of the "gross income from mining". "Mining" was defined in Section 613(c)(2) for the years in issue here as including "not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products", including a limited amount of transportation.

Section 39.23(m)-1(e)(3) of Treasury Regulations 118 provides that a taxpayer's depletable "gross income from mining" is its gross sales if it sells the crude mineral product of its "ordinary treatment processes" in the immediate vicinity of the mine. If, before sale, the mineral is subjected to non-mining processes or transported beyond the limit set in the statutory definition of mining, then the depletion basis is not gross sales but "the representative market or field price * * * of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied * * *." To cover situations such as the present case where there is no representative market or field price for the raw mineral

the regulation prescribes the computation of "gross income from mining" as follows:

> there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes * * * minus the costs and proportionate profits attributable to the transportation (other than transportation treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes. * * *

The regulation concludes with the proviso that a taxpayer may use any other method of computation if the Commissioner is satisfied that the proposed method clearly reflects gross income from mining. This regulation has been in force in substantially the same form since 1940. Section 19.23(m)-1(f) of Treasury Regulations 103 under the 1939 Code.[4]

Petitioner claims that the court of appeals (Pet. 30) "was unable to comprehend the basics of accounting and economics, refused to be informed therein, had a misunderstanding of the facts", and (Pet. 45) "completely disregards the findings of the District Court * * *." This contention ignores that determination of the "gross income from mining" of an integrated producer "clearly calls for a legal determination of Congressional intent and not a factual choice of the proper and acceptable accounting treat-

[4] Petitioner is incorrect in its assertion (Pet. 31) that the proportionate profits provision of the regulations was "inoperative until 1961", when it first came before the courts. It has been fully operative in administrative application since it was first promulgated in 1940.

ment * * *." *Standard Lime and Cement Co.* v. *United States*, 329 F. 2d 939, 946 (C. Cl.).

Thus the regulation should be sustained unless it is unreasonable or inconsistent with the statutes. *E.g.*, *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501, rehearing denied, 334 U.S. 813. In the depletion area, Congress has placed particular emphasis on the need for administrative regulations because it "could not foresee the multifarious circumstances which would involve questions of depletion." *Douglas* v. *Commissioner*, 322 U.S. 275, 281. Moreover, "the highly technical and involved factors entering into a practical solution of the problem of depletion in administration of the tax laws points to the necessity of interpreting * * * [the applicable statute] so as to strengthen rather than to weaken the administrative powers to deal with it equitably and reasonably". *Helvering* v. *Wilshire Oil Co.*, 308 U.S. 90, 103, rehearing denied, 308 U.S. 638.

Section 613 makes gross income from mining the basis for computing depletion. The activities that comprise mining are defined in the same section. An integrated miner-manufacturer's depletion basis is therefore his constructive income from the mining phase of his operations; income from other operations must be eliminated from gross revenues before the depletion allowance is computed. *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76; *Riddell* v. *Monolith Cement Co.*, 371 U.S. 537. The proportionate profits method is prescribed for computing constructive mining income where the product of mining is

not marketed. It defines mining income as all costs attributable to the operations encompassed within the statutory definition of mining, plus the profits, or less the loss, attributable to these costs on the assumption that each dollar of cost produces an equal amount of profit or loss. This assumption, as must any, results in an approximation. But in the absence of a market price for the raw material any method of determining constructive income would produce an approximation. The Commissioner's proportionate profits method is certainly a reasonable one as well calculated as any to implement the statute.

No court has ever questioned the validity of the method or suggested that some other administrative method would be more appropriate in the generality of cases where the raw material is not sold in the open market. The proportionate profits method has been applied, without qualification, to other miner-manufacturers of cement. *E.g., Whitehall Cement Manufacturing Co.* v. *United States,* 369 F. 2d 468 (C.A. 3), where the court rejected the taxpayer's contention that the method was unfair unless modified, and *Standard Lime and Cement Co.* v. *United States,* 329 F. 2d 939 (C. Cl.). Indeed, the proportionate profits method has been held to reflect "gross income from mining" more clearly than actual market prices that were deemed unrepresentative. *United States* v. *Henderson Clay Products,* 324 F. 2d 7 (C.A. 5), certiorari denied, 377 U.S. 917; cf. *United States Pipe & Foundry Co.* v. *Patterson,* 203 F. Supp. 335, 364 (N.D. Ala.).

If, in a particular case, a taxpayer can demonstrate to the satisfaction of the Commissioner that another

method more clearly reflects his mining income, he may use it in lieu of the proportionate profits method. But petitioner has satisfied neither the Commissioner nor the Tenth Circuit that such is the case here. Petitioner's proposed method is to add together the market costs of the separate minerals that are found in combination in petitioner's cement rock. But the question is the constructive income from petitioner's peculiar mineral, which is certainly not the same as the cost of a combination of other materials that may be substituted for petitioner's. See *United States* v. *Toronto Nav. Co.*, 338 U.S. 396, 403. Under these circumstances, petitioner has not discharged the heavy burden of proof necessary to overturn a Treasury regulation.

2. Petitioner contends (Pet. 17–19 *et seq.*) that the proportionate profits method is invalid under *Cannelton*. *Cannelton* defines an integrated producer's "gross income from mining" as the constructive income [5] from its mineral "at the cut-off point."

Petitioner contends (Pet. 19) that the court of appeals "erred in setting the cut-off point prior to fin-

[5] Petitioner is equally in error in contending that the proportionate profits method does not determine the value of the mineral at cutoff point. It is true that, in the passages in *Cannelton* quoted by petitioner (Pet. 17–18), this Court speaks of the "value" of the raw minerals as the taxpayer's "gross income from mining." In other passages, however, the Court equates value with (364 U.S. at p. 86) "the constructive income from the raw mineral product, if marketable in that form * * *." The absence, as here, of an established market for petitioner's raw material equally requires the determination of a "constructive income" from mining. That is precisely what the proportionate profits method does.

ished cement" because its mineral could not be "marketed" prior to that time. This contention is based on its earlier assertion (Pet. 6–10) that the mining cut-off point for depletion purposes must be based on actual sales by the taxpayer claiming depletion or, in their absence, sales by others of a like material. There is no merit to such a reading of *Cannelton* and *Monolith*.

In *Cannelton* the taxpayer was an integrated miner-manufacturer who mined fire clay and shale and manufactured them into sewer pipe and other vitrified products. The taxpayer claimed that the manufactured products were its first "commercially marketable" products. It argued that its raw clay and shale were not "marketable" because it could not sell them at a profit, given its underground method of mining. Rejecting these contentions, this Court held that (364 U.S. at p. 86) raw minerals are "commercially marketable" within the meaning of the statute when they are "ready for industrial use or consumption", without regard to whether or not a taxpayer can sell them at a profit. The Court held further that (p. 89) "Congress intended integrated mining-manufacturing operations to be treated as if the operator were selling the mineral mined to himself for fabrication", and that an integrated taxpayer's constructive "gross income from mining" should be computed at the processing point where a non-integrated miner would be ready to ship and sell the raw minerals. This result did not depend on the fact that other miners sold the same type of raw material *Cannelton* mined. Rather, those sales

were seen (p. 86) as additional and "conclusive proof" that the minerals were "ready for industrial use or consumption".

In *Monolith,* as here, an integrated miner-manufacturer of cement contended, as does petitioner, that the absence of an actual market for and sales of its raw mineral distinguished the case from *Cannelton* and required the conclusion that the raw material was not "commercially marketable". The Ninth Circuit agreed. 301 F. 2d 488. In reversing, this Court held that the taxpayer's "mining" ended for depletion purposes with the crushing of the limestone, because this was the point where the raw mineral, 371 U.S. at p. 538, "first became suitable for industrial use or consumption". This Court did not deem the matter of actual sales sufficiently important to discuss in the text of its opinion, merely observing in a footnote that there were sales of crushed limestone for purposes other than the manufacture of cement.

In sum, it is clear under *Cannelton* and *Monolith* that the absence of open market sales of a raw mineral is not material. The integrated miner-manufacturer is deemed to be his own market or customer; his "mining" ends for depletion purposes when his raw mineral is in shipping form for delivery to and consumption by manufacturers; and his "gross income from mining" must be computed accordingly. Accord, *Solite Corp.* v. *United States,* 375 F. 2d 684 (C.A. 4), certiorari denied, October 9, 1967, 36 U.S. Law Week 3144; *United States* v. *Light Aggregates, Inc.,* 343 F. 2d 429 (C.A. 8); *United States* v. *Longhorn*

Portland Cement Co., 328 F. 2d 491 (C.A. 5); *Virginia Greenstone Co.* v. *United States*, 308 F. 2d 669 (C.A. 4).[6]

3. Petitioner gives hypothetical examples of situations (Pet. 21 *et seq.*) in which it asserts the proportionate profits method would produce an arbitrary and unreasonable result.

However, as the court of appeals has pointed out (Pet. App. H–6–H–8), petitioner has failed to prove that the method gives distorted results in this particular case, or discriminates against petitioner in relation to other producers. Further, the proportionate profits method is arbitrary only to the extent that percentage depletion itself is arbitrary. As this Court said in *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308, 312:

> The present allowance, however, bears little relationship to the capital investment, and the taxpayer is not limited to a recoupment of his original investment. The allowance continues so long as minerals are extracted, and even though no money was actually invested in the deposit. * * *

In other words, a taxpayer may recover the value of his minerals in place many times over, under the arbitrary, industry-wide percentage depletion provisions. In thus permitting a percentage depletion allowance, Congress has necessarily tied the allowance to income actually or constructively realized from mining operations without regard to the value of the mineral.

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[6] *Dragon Cement Co.* v. *United States*, 244 F. 2d 513 (C.A. 1), certiorari denied, 355 U.S. 833, is to the contrary, but was decided before *Cannelton* and *Monolith*.

4. There is nothing to petitioner's contention (Pet. 43–46) that it has been denied due process. All of the possible theories applicable to this case have been thoroughly aired during the course of four appeals, and petitioner has had its day in court several times over. Moreover, since *Stanton* v. *Baltic Mining Co.*, 240 U.S. 103, it has been settled that there is no constitutional right to a depletion deduction under the Sixteenth Amendment. See cases cited in *Anderson* v. *Helvering*, 310 U.S. 404, 407–408.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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NOVEMBER 1967.

*In lieu of the Solicitor General, who has disqualified himself in this case.

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